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IN THE

Supreme Court of the United States

TELLABS, INCORPORATED and RICHARD C. NOTEBAERT,

Petitioners,

—v.—

MAKOR ISSUES & RIGHTS, LTD., *et al.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR NEW ENGLAND LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

New England Legal Foundation ("NELF") is a non-profit, public interest law firm that was founded in 1977. Its membership consists of corporations, law firms, individuals, and others who believe in NELF's mission of promoting balanced economic growth for New England, protecting the free enterprise system, and defending economic rights. NELF's more than 130 members and supporters include a cross-section of large and small corporations from all parts of New England and the United States. NELF has regularly appeared in state and federal courts, as party or counsel, in cases raising issues of general economic significance to the New England and national business communities. *E.g.*, *Watters* v. *Wachovia Bank, N.A.*, No. 05-1342 (U.S. argued Nov. 29, 2006); *Rapanos* v. *United States*, 126 S. Ct. 2208 (2006); *S.D. Warren Co.* v. *Maine Bd. of Envtl. Protection*, 126 S. Ct. 1843 (2006); *Kelo* v. *City of New London*, 545 U.S. 469 (2005); *Green Tree Fin. Corp.* v. *Bazzle*, 539 U.S. 444 (2003); *EEOC* v. *Waffle House, Inc.*, 534 U.S. 279 (2002); *Palazzolo* v. *Rhode Island*, 533 U.S. 606 (2001); *Crosby* v. *National Foreign Trade Council*, 530 U.S. 363 (2000); *UNUM Life Ins. Co.* v. *Ward*, 526 U.S. 358 (1999).

SUMMARY OF ARGUMENT

At issue in this case is what it means, under the Private Securities Litigation Reform Act of 1995, to require a plaintiff in a private securities fraud action to "state

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[1] Pursuant to Rule 37.6, NELF states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than NELF or its counsel made a monetary contribution to the preparation or submission of this brief. The parties' general letters of consent to the filing of *amicus* briefs have been filed with the Clerk's office.

with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Congress did not choose that language at random. Part of it—the "facts giving rise to a strong inference" part—comes directly from cases in the Second Circuit applying Federal Rule of Civil Procedure 9(b). In those cases, the Second Circuit held that plaintiffs in fraud cases had to plead "facts giving rise to a strong inference of fraudulent intent." At the same time, however, because the text of Rule 9(b) provides that "[m]alice, intent, knowledge, and other condition of mind of a person may be averred generally," the Second Circuit tempered its "strong inference" standard by holding that "great specificity" was not required; a "minimal factual basis" would suffice.

Congress's choice of words clearly evinces an intent to toughen this standard. Unlike Rule 9(b)—which explicitly exempts state of mind from the facts that must be "stated with particularity"—the PSLRA *requires* that facts as to a defendant's state of mind be "state[d] with particularity." And the legislative history confirms that Congress meant to create a new and stricter pleading standard. Not only did the Conference Report on the final bill explicitly say that "the Conference Committee intends to *strengthen* existing pleading requirements,"[2] but President Clinton vetoed the bill precisely because he understood Congress had made "crystal clear . . . [its] intent to raise the [pleading] standard *even beyond*" existing Rule 9(b) case law and "to erect a *higher* barrier to bringing suit than any now existing."[3]

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[2] H.R. CONF. REP. NO. 104-369, at 41 (1995) (emphasis added).

[3] Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, H.R. DOC. NO. 104-150 (emphasis added), *reprinted in* 141 CONG. REC. H15214-15 (daily ed. Dec. 20, 1995). Congress overrode the President's veto. 141 CONG. REC. D1511 (daily ed. Dec. 22, 1995).

All of this means that the decision of the Seventh Circuit below cannot stand. The standard applied by the Seventh Circuit—which would sustain any complaint from which "a reasonable person *could* infer" scienter, Pet. App. 20a (emphasis added)—applies a "reasonable inference" standard that is contrary to the "strong inference" language of the statute itself. Indeed, the Seventh Circuit's standard threatens to revive the discredited practice of pleading "fraud by hindsight," widely rejected even before the PSLRA's passage. The Seventh Circuit's "reasonable inference" standard accomplishes exactly the opposite of what Congress intended, because it allows plaintiffs to bring exactly the sorts of ill-founded claims that the PSLRA was intended to bar.

ARGUMENT

I. THE PSLRA ESTABLISHES A SCIENTER PLEADING STANDARD MORE STRINGENT THAN THE STRICTEST INTERPRETATION OF FED. R. CIV. P. 9(B).

A. The PSLRA's language was borrowed, in part, from the Second Circuit's strict scienter pleading standard.

The PSLRA requires plaintiffs to plead "*facts giving rise to a strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). When it was enacted into law in 1995, that language was not new to the realm of private securities fraud litigation. The very same "strong inference" language appears in a line of Second Circuit cases dating back to the 1970s. Those cases consistently held that, in any civil case involving an allegation of fraud, Federal Rule of Civil Procedure 9(b) required plaintiffs to allege "*facts giving rise to a strong inference* of fraud-

ulent intent." *Acito* v. *IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995) (emphasis added).[4]

At the time the PSLRA was passed, "the Second Circuit's 'strong inference' standard was the most stringent among the Courts of Appeals." *Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 407 (5th Cir. 2001); *accord, e.g., In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 (6th Cir. 1999). Other courts of appeals used less forceful formulations, ones that did not use the word "strong"—requiring, for example, that a complaint "set forth specific facts that make it reasonable to believe that defendant knew that a statement was materially false or misleading," *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (Breyer, Ch. J.); that a complaint "afford a basis for believing that plaintiffs could prove scienter," *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990); or that it "set forth specific facts that support an inference of fraud," *Tuchman* v. *DSC Communications Corp.*, 14 F.3d 1061, 1067 (5th Cir. 1994).

Some courts rejected the Second Circuit's approach on the ground that it was inconsistent with the text of Rule 9(b). The first sentence of Rule 9(b) requires "particu-

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[4] *Accord, e.g., Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) ("to serve the purposes of Rule 9(b), we require plaintiffs to allege facts that give rise to a strong inference of fraudulent intent"); *Mills* v. *Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993) ("a 10b-5 complaint . . . must allege facts that raise a strong inference of fraudulent intent"); *Beck* v. *Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987) ("factual allegations must give rise to a 'strong inference' that the defendants possessed the requisite fraudulent intent"); *Ross* v. *A.H. Robins Co., Inc.*, 607 F.2d 545, 558 (2d Cir. 1979) ("requir[ing] that plaintiffs specifically plead those events which they assert give rise to a strong inference that the defendants had knowledge of the [allegedly omitted or misstated] facts . . . or recklessly disregarded their existence").

larity" only as to the "circumstances constituting fraud or mistake"—

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be alleged with particularity.

—and the second and last sentence provides that "intent, knowledge and other condition of mind" need only be "averred generally":

> Malice, intent, knowledge, and other condition of mind of a person can be averred generally.

FED. R. CIV. P. 9(b). The Ninth Circuit, for example, held that "the Second Circuit's test . . . is irreconcilable with the second sentence of Rule 9(b)," and that "Rule 9(b) does not require '*any* particularity in connection with an averment of intent, knowledge or condition of the mind.' " *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc; citation omitted).

For its part, the Second Circuit attempted to harmonize its "strong inference" standard with Rule 9(b)'s text by significantly tempering the standard with language that Congress ultimately did *not* put into the PSLRA. The court acknowledged that, for allegations of "condition of mind" such as scienter, the second sentence of Rule 9(b) represented a "relaxation of [the] specificity requirement" contained in the first sentence of the rule. *Acito*, 47 F.3d at 52; *accord Shields* v. *Citytrust Bancorp. Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994). The court thus held that "allegations of scienter . . . 'are not subjected to the more exacting consideration applied to the other components of fraud,' " *Breard* v. *Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 143 (2d Cir. 1991) (quoting *Ouaknine* v. *MacFarlane*, 897 F.2d 75, 81 (2d Cir. 1990))—and that, accordingly, " 'scienter need *not* be alleged with great specificity.' " *IUE AFL-CIO Pension*

Fund v. *Herrmann*, 9 F.3d 1049, 1057 (2d Cir. 1993) (quoting *Ouaknine*, 897 F.2d at 79-80; emphasis added).[5] Instead, the Second Circuit required plaintiffs to plead only "a *minimal* factual basis for their conclusory allegations of scienter." *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 960 (2d Cir. 1987) (emphasis added).[6]

One way of establishing a "minimal factual basis" for scienter, under the Second Circuit's standard, was "through allegations of a motive to deceive and access to accurate information." *Cohen* v. *Koenig*, 25 F.3d 1168, 1173-74 (2d Cir. 1994). In other words, a plaintiff could establish the required inference of scienter by "alleg[ing] facts showing a motive for committing fraud and a clear opportunity for doing so." *Beck* v. *Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987). Known as the "motive and opportunity test," this hold-

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[5] *Accord, e.g.*, *Cohen* v. *Koenig*, 25 F.3d 1168, 1173 (2d Cir. 1994) ("the language of Rule 9(b) means that 'great specificity [is] not required with respect to . . . allegations of . . . scienter' "; citations omitted); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) ("[s]cienter . . . need not be pleaded with 'great specificity' "; citation omitted); *Wexner* v. *First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) ("scienter need not be alleged with great specificity"); *Connecticut Nat'l Bank* v. *Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) ("Consistent with the language of the Rule [9(b)], we have recognized that 'great specificity [is] not required with respect to . . . allegations of . . . scienter' ").

[6] *Accord, e.g.*, *Powers* v. *British Vita, P.L.C.*, 57 F.3d 176, 184 (2d Cir. 1995) ("plaintiff must 'provide some minimal factual basis for conclusory allegations of scienter' "; citation omitted); *Cohen*, 25 F.3d at 1173 ("plaintiffs have the 'burden of pleading circumstances that provide at least a minimal factual basis for their conclusory allegations of scienter' "; citation omitted); *see also San Leandro Emergency Medical Group Profit Sharing Plan* v. *Philip Morris Cos., Inc.*, 75 F.3d 801, 813 (2d Cir. 1996) ("minimal factual basis"; citation and internal quotation marks omitted); *Chill* v. *General Electric Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (same).

ing was something of a shortcut to pleading scienter. It allowed plaintiffs to plead fraud *without* pleading "strong circumstantial evidence of conscious misbehavior or recklessness." *Acito*, 47 F.3d at 52. The "motive and opportunity test" made it easier to plead fraud, and "lower[ed] the bar for securities fraud cases," because "[g]reed is a ubiquitous motive, and corporate insiders and upper management always have opportunity to lie and manipulate." *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999) (citation and internal quotation marks omitted).

The PSLRA did not incorporate any of the Second Circuit's efforts to soften the "strong inference" test. Most importantly, the PSLRA's language directly *contradicts* the holdings that scienter allegations must be subjected to a "relaxed" standard of particularity, that only a "minimal factual basis," and not "specificity," are required, and that, in accordance with Rule 9(b), allegations of conditions of mind "are not subjected to the more exacting consideration applied to the other components of fraud." By its express terms, the PSLRA's pleading standard merges *the "particularity" language of the first sentence of Rule 9(b)* with the "strong inference" language in the Second Circuit case law, and applies it to the state of mind requirement—

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, *the complaint shall*, with respect to each act or omission alleged to violate this title, *state with particularity* facts giving rise to a strong inference that the defendant acted with the required state of mind.

—and, in doing so, plainly *strengthened* the standard that the Second Circuit had applied under Rule 9(b). 15

U.S.C. § 78u-4(b)(2) (emphasis added). Beyond that, the "Reform Act . . . makes *no* express mention of the motive and opportunity test developed in the Second Circuit, and certainly does not expressly codify it." *Bryant*, 187 F.3d at 1285 (emphasis added).

In short, even without resort to legislative history, Congress's choice of language in establishing the PSLRA's pleading standard makes clear its intent to create a pleading standard higher than any standard previously applied under Rule 9(b).

B. The legislative history makes clear that Congress was establishing a pleading standard more stringent than any that existed under Rule 9(b).

The legislative history of the PSLRA confirms that Congress intended to establish a pleading standard that was stricter than that applied by the Second Circuit or any other court. The bill reported by the Senate Banking Committee, S. 240, contained language similar to that ultimately adopted, but instead of using the word "particularity," provided that a "complaint shall . . . *specifically* allege facts giving rise to a strong inference that the defendant acted with the required state of mind." S. 240, 104th Cong. § 104(b) (as reported by S. Comm. on Banking, Housing and Urban Affairs, June 19, 1995; emphasis added). The Senate report explained that the bill was based partially, but not entirely, upon the Second Circuit's Rule 9(b) standards. The committee explained that the bill "does not adopt a new and untested pleading standard," and instead creates a "a uniform standard modeled upon the pleading standard of the Second Circuit[,] [r]egarded as the most stringent pleading standard." Nevertheless, the committee emphasized that it "does not intend to codify the Second Circuit's

caselaw interpreting this pleading standard." S. REP. NO. 104-98, at 15 (1995).

During the Senate floor debate on S. 240, Senator Specter proposed an amendment that set forth the "motive and opportunity" test and other language from the Second Circuit's cases. Senator Specter argued that, if the part of the Second Circuit's case law that was tough on plaintiffs should be included, then, in fairness, so should the part that accommodated them:

> This is just basic fundamental fairness that if you take the second circuit standard, you ought to take the entire standard, which is very tough on plaintiffs to establish state of mind, which is hard to prove.

141 CONG. REC. S9200 (daily ed. June 28, 1995) (statement of Sen. Specter). Senator Specter's amendment passed and became part of the bill that went to the Conference Committee. S. 240, 104th Cong. § 104(b), 141 CONG. REC. S9219, S9222 (as passed by the Senate, June 28, 1995). The Senate bill that went to the Conference Committee thus provided that "a strong inference that the defendant acted with the required state of mind may be established . . . by alleging facts to show that the defendant had both motive and opportunity to commit fraud." *Id.*

The conferees, however, deleted the Specter amendment, explaining that the proposed pleading requirement in the final bill was only "based *in part* on the pleading standard of the Second Circuit." H.R. CONF. REP. 104-369, at 41 (1995) (emphasis added). And the conferees made clear that the intent was to toughen existing pleading standards: "Because the Conference Committee intends to *strengthen* existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id.* (emphasis added). In

a direct reference to the Specter amendment, moreover, the Committee went on to explain that, "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive [and] opportunity . . . ." *Id.* at 41 n.23 (emphasis added). This explanation clearly states Congressional intent. *E.g.*, *Garcia* v. *United States*, 469 U.S. 70, 76 (1984) (conference reports are the best authoritative source of legislative intent).

So, too, did the President understand that this was what Congress intended when he vetoed the PSLRA. In his message to Congress, President Clinton explained that he was returning the legislation *precisely because* Congress had made "crystal clear . . . [its] intent to raise the [pleading] standard *even beyond*" that of the Second Circuit, and "to erect a *higher* barrier to bringing suit than any now existing":

> I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. *But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.*
>
> The conferees deleted an amendment offered by Senator Specter and adopted by the Senate that specifically incorporated Second Circuit case law with respect to pleading a claim of fraud. Then they specifically indicated that they were not adopting Second Circuit case law but instead intended to "strengthen" the existing pleading requirements of the Second Circuit. *All this shows that the conferees meant to erect a higher barrier to bringing suit than any now existing . . . .*

Private Securities Litigation Reform Act of 1995—Veto Message from the President of the United States, H.R. DOC. NO. 104-150 (emphasis added), *reprinted in* 141 CONG. REC. H15214-15 (daily ed. Dec. 20, 1995).[7]

In short, the history of the enactment of the PSLRA confirms what a comparison of the statute's language to prior case law makes clear: that Congress plainly intended to establish a securities fraud pleading standard that was stricter than any that had ever been applied before.

II. THE SEVENTH CIRCUIT'S DECISION IS INCONSISTENT WITH THE PSLRA'S LANGUAGE AND PURPOSE.

The pleading standard applied by the Seventh Circuit in this case clearly contradicts both the language and the purpose of the PSLRA. The Seventh Circuit held that a securities fraud complaint must be sustained "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." Pet. App. 20a (emphasis added). Under this standard, a district court must uphold any complaint that raises any "reasonable," though not "strong," inference of scienter, and cannot consider whether an inference of a defendant's innocence was as plausible as, or more plausible than, an inference of culpability. That standard, however, amounts to little more than notice pleading, and does not come close to requiring a "strong inference" of scienter. Congress intended to raise the bar to securities fraud claims; the Seventh Circuit's "reasonable inference" standard would lower the bar, even below standards prevailing before the PSLRA.

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[7] Congress overrode the President's veto. 141 CONG. REC. D1511 (daily ed. Dec. 22, 1995).

A. Determination of what constitutes a "strong inference" necessarily requires weighing competing inferences.

Even apart from the historical backdrop of the PSLRA pleading standard, the Seventh Circuit's decision cannot be reconciled with the plain meaning of "strong inference." Not every inference that "*could*" be drawn is strong; a *strong* inference is one that overcomes other possible inferences. "Strong," in a logical sense, means "striking or *superior of its kind*: capable of making a clear or deep impression esp. on the mind or imagination." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2265 (1986) (emphasis added). In the context "[o]f argument, evidence, [and] proof," it means "[p]owerful to demonstrate or convince; *hard to confute or overthrow*." 16 OXFORD ENGLISH DICTIONARY 949 (2d ed. 1989) (emphasis added).[8]

A *strong* inference, then, is one that is superior to other inferences, is hard to confute, and thus can endure or withstand challenges from other inferences. Assessing whether an inference of fraudulent intent is strong *necessarily* entails precisely what the Seventh Circuit abjured: a reasoned conclusion as to whether that inference is powerful enough to overcome other, more innocent inferences. And it makes no sense to say, as the Seventh Circuit seems to have concluded, that a given set of pleaded facts could simultaneously give rise to *strong* inferences of *both* innocence and guilt.

In light of its plain language, a plurality of circuits have interpreted the PSLRA's strong inference requirement to mean that "plaintiffs are entitled only to the

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[8] *See also* BLACK'S LAW DICTIONARY 1463 (8th ed. 2004) (defining "strongly corroborated" as evidence that is "powerful, satisfactory, and clear").

most plausible of competing inferences." *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc); *accord, e.g., In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005) ("Scienter allegations do not pass the 'strong inference' test when . . . there are legitimate explanations for the behavior that are equally convincing."); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003) (finding no "strong inference" of scienter where alleged misstatement "was just as likely the result of an overgeneralization as it was the product of intentional deception or recklessness"); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002) (holding that consideration of an "equally if not more plausible" inference of innocence "clearly impedes the plaintiffs' progress toward building the requisite strong inference of scienter").

The Seventh Circuit's "could infer" standard is, at the very least, a retreat to the weaker standard previously applied under Rule 9(b). And it is so vague that it threatens to revive the discredited approach of pleading "fraud by hindsight." A fraud-by-hindsight complaint typically "records statements by defendants predicting a prosperous future and holds them up against the backdrop of what actually transpired." *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1129 (2d Cir. 1994). As Judge Easterbrook put it:

> The story . . . is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud.

DiLeo v. *Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990).

One inference that *could* be drawn from this fact pattern may be described as

> [t]he 'hindsight' [of] inferring, from later poor performance, earlier knowledge that such later performance was likely,

or

> [t]he 'hindsight' [of] inferring, from a later [event], earlier knowledge that such [an event] was likely.

Greenstone v. *Cambex Corp.*, 975 F.2d at 25-26 (Breyer, Ch. J.). But even before the PSLRA, such an inference could not save a complaint from dismissal. As then-Chief Judge Breyer, applying the First Circuit's pre-PSLRA standard, explained:

> Were the law otherwise, a complaint could evade too easily the "particularity" requirement in Rule 9(b)'s first sentence. Suppose, for example, that in 1991 a corporation projects substantial revenues in the upcoming year. Suppose the corporation's actual 1992 sales are 50% less than predicted. To permit a securities fraud complaint to state, without more, that the corporation's executives "knew" in 1991 about the likely decline in 1992 sales would sanction what Judge Friendly called 'fraud by hindsight," *Denny* v. *Barber*, 576 F.2d 465, 470 (2d Cir. 1978), a practice that courts have not allowed.

Id. at 25.

Courts did not allow this practice because it "would too easily allow the inference that ordinary business reverses are fraud." *DiLeo*, 901 F.2d at 629. The "fraud-by-hindsight" cases implicitly weighed inferences, and they rejected inferences of fraud that were too weak to overcome inferences that the business reversal reflected events that either had not happened or whose signifi-

cance was not understood at the time of the allegedly fraudulent announcements. In adopting the PSLRA, Congress mandated even greater scrutiny of securities fraud complaints. To conclude that a court may not weigh competing inferences under the PSLRA thus ignores both logic and history.

B. The Seventh Circuit's standard would defeat the paramount congressional purpose of curbing frivolous and costly litigation.

This Court has long recognized the unique "danger of vexatiousness" presented by securities fraud class actions. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975). "[T]o the extent that [a securities fraud case] permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, . . . it is a social cost rather than a benefit." *Id.* at 741. The settlement value of such a case, even a case "which by objective standards may have very little chance of success at trial," is greatly enhanced if plaintiff can "prevent the suit from being resolved against him by dismissal." *Id.* at 740-41.

Similar concern with securities fraud class action abuses prompted Congress to enact the PSLRA. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510-11 (2006). The conference report on the bill decried "the abuse of the discovery process to impose costs so burdensome that it is often economical . . . to settle" and "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer." H.R. CONF. REP. NO. 104-369, at 31 (1995). These lawsuits, the conference report said, were a national menace: "the entire U.S. economy ha[s] been injured by the unwillingness of

the best qualified persons to serve on boards of directors . . . because of fear of baseless and extortionate securities lawsuits." *Id.* at 31-32. "The fact that many of these lawsuits are filed as class actions has had an in terrorem effect on Corporate America," the Senate Banking Committee observed. S. REP. NO. 104-98, at 9 (1995). "These lawsuits have added significantly to the cost of raising capital and represent a 'litigation tax' on business." *Id.* (footnote omitted).

The social cost of securities fraud class actions has been growing, both nationally and regionally, since the PSLRA's passage in 1995. For example, contrary to Congress's intent in enacting the PSLRA to help ensure that "capital formation and investment may grow for the benefit of all Americans," *id.* at 31, private securities litigation is discouraging capital formation and investment in American markets. As the bipartisan Committee on Capital Markets Regulation recently observed, the data show that it is "undeniable" that the size of securities class-action settlements has been "soaring."[9] As a consequence, the cost of directors' and officers' insurance for American companies is more than six times what it is for their European counterparts.[10] This is highly detrimental to capital formation in the United States, because "[a]s average settlement values climb, so do the incentives for companies to try to evade private litigation under the U.S. securities laws by simply choosing to sell their shares elsewhere."[11]

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[9] COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 75 (Nov. 30, 2006), *available at* http://www.capmktsreg.org/pdfs/11.30 Committee_Interim_ReportREV2.pdf. The Committee, which U.S. Treasury Secretary Henry Paulson has endorsed, is composed of 22 corporate and financial leaders from business, finance, law, accounting, and academia.

[10] *Id.* at 78.

[11] *Id.*

Similarly, a recent report issued by New York City Mayor Michael Bloomberg and Senator Charles E. Schumer compiles evidence showing that businesses and investors are responding to these incentives: "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors."[12] The report, for example, details how, in the view of executives in the financial services sector, "New York City is seen as being significantly behind London" in "the quality of the legal system," and notes that "America's general propensity for litigation [is] the biggest driver behind New York City's problems in this area."[13] The report also remarks how "2005 [not only] set a new record for the highest-ever number of securities class-action settlements," but how "the overall value of these settlements overshadowed every prior year," with "the securities industry [bearing] a disproportionate share of the overall cost."[14] That is one reason why, from 2002 to 2005, "London's financial services workforce expanded by 4.3 percent," while "New York City's financial services employment fell by 0.7 percent."[15]

Technology, biotech, and other high-growth industries are also hard hit by securities fraud class actions.

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[12] MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP ii (Jan. 22, 2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf.

[13] *Id.* at 73; *see also id.* at 73, 75 ("[T]he American [litigation] environment [is] seen as expensive and unpredictable" as compared to London's"; "85 percent [of CEOs surveyed] indicated that London['s legal environment] was preferable, and not a single one chose New York.").

[14] *Id.* at 74.

[15] *Id.* at 64.

"[B]ecause of the volatility of their stock prices," such companies "are particularly vulnerable to securities fraud lawsuits when projections do not materialize. If a company fails to satisfy its announced earnings projections . . . the company is likely to face a lawsuit." H.R. CONF. REP. NO. 104-369, at 43; *see also* H.R. REP. NO. 104-50, at 15-16 (Feb. 24, 1995) (describing high technology companies as "easy prey for plaintiffs' lawyers who want to file speculative suits"). As a result, at the time of the PSLRA's passage, some directors' and officers' insurance carriers had simply "stopped writing policies for companies in . . . the technology sector." S. REP. NO. 104-98, at 21. The sector remains vulnerable today, experiencing the second highest rate of such filings of any industry in 2006. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION CASE FILINGS: 2006, at 17 (2007), *available at* http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf.[16]

There is also a growing recognition that securities fraud class actions do not appropriately compensate defrauded investors, particularly diversified investors. Diversified investors hold a majority of the shares traded on public securities markets.[17] These investors—who are

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[16] As defined in the Cornerstone report, the technology sector includes "computers, office/business equipment, semiconductors, and software." *Id.* at 17 n.11. The "communications" sector—which includes most Internet-related companies—was tied for third most securities class action filings in 2006. *Id.* at 17.

[17] The proportion of shares held by institutional investors—including pension funds, mutual funds, and insurance companies—has been increasing for decades. Such investors, which are typically diversified, held 61.3% of outstanding equity securities by 2001. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 729-30 (5th ed. 2004). Most retail investors also diversify. John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COLUM. L. REV. 1534, 1559 & nn.91 & 92 (2006).

just as likely to own shares of companies forced to pay securities fraud settlements as to be class members who benefit from such settlements—"are made worse off by securities litigation, because settlements from such lawsuits provide money to plaintiffs' left hand pocket by taking it from their right-hand pocket, with a substantial commission to the plaintiffs' attorneys for facilitating the transaction." Hearing before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (June 28, 2006) (statement of Theodore H. Frank), *available at* 2006 WL 1789362.[18] Thus, while securities fraud litigation undoubtedly shifts resources to the professional plaintiffs' bar, it does not rationally compensate defrauded investors.

If permitted to stand, the Seventh Circuit's "reasonable inference" standard thus would exacerbate the social costs of securities litigation with no offsetting benefits to investors or the public. The standard is a step backward, one that frustrates efforts to adjust the securities laws to the needs of the national securities markets.

III. THE "REASONABLE INFERENCE" STANDARD IS NOT COMPELLED BY THE SEVENTH AMENDMENT.

The Seventh Circuit did not look to statutory language, purposes or history to justify the "reasonable inference" standard. Rather, the court expressed concern that a stricter standard "could potentially infringe upon

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[18] *See also* Neil Weinberg, *Cui Bono?*, FORBES, April 25, 2005, at 40 (calculating that the New York Common Retirement Fund, lead plaintiff in the WorldCom class action, would recover *less* in the $6 billion settlement than its pro rata share, based on its current equity holdings, of the losses incurred by the settling banks).

plaintiffs' Seventh Amendment rights." Pet. App. 20a. The Seventh Amendment, however, provides no reason to misread the "strong inference" standard as one requiring merely a plausible inference. As this Court made clear in *Parklane Hosiery Co., Inc.* v. *Shore*, 439 U.S 322 (1979), the Seventh Amendment "has never been interpreted in a rigid manner," and "the Amendment was designed to preserve the basic institution of jury trial in only its most fundamental elements, not the great mass of procedural forms and details, varying even then so widely among common-law jurisdictions." *Id.* at 336-37 (*quoting Galloway* v. *United States*, 319 U.S. 372, 392 (1943)). As this Court held long ago, moreover, "[t]he Seventh Amendment . . . does not attempt to regulate matters of pleading or practice." *Walker* v. *New Mexico & S. Pac. R.R. Co.*, 165 U.S. 593, 596 (1897); *see also United Air Lines, Inc.* v. *Wiener*, 335 F.2d 379, 406-07 (9th Cir. 1964) (same).

The PSLRA's specification of the pleading standard for securities fraud class actions can hardly be said to threaten the "basic institution of jury trial." Indeed, this Court has consistently upheld procedural innovations that far more closely relate to a jury's function than does the PSLRA pleading standard. It has held, for example, that the directed verdict does not violate the Seventh Amendment. *Galloway*, 319 U.S. at 388-93. It has held that a retrial limited to the question of damages does not violate the Seventh Amendment, even though there was no practice at common law for setting aside a verdict in part. *Gasoline Products Co.* v. *Champlin Refining Co.*, 283 U.S. 494, 497-98 (1931). And it has held that summary judgment does not violate the Seventh Amendment. *Fidelity & Deposit Co.* v. *United States*, 187 U.S. 315, 319-21 (1902).

Even where the *evidence*—as opposed to a pleading—is ambiguous, this Court has approved granting both summary judgment and directed verdict, thus taking the case away from the jury, without any suggestion that the Seventh Amendment was implicated:

- In *Matsushita Electric Industrial Co., Ltd.* v. *Zenith Radio Corp.*, this Court held, in a case under Section 1 of the Sherman Act, that "conduct *as consistent with* permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy." 475 U.S. 574, 588 (1986). The Court explained that summary judgment was appropriate even "if petitioners had had *a plausible reason* to conspire," because "*ambiguous* conduct" could not "suffice to create a triable issue of conspiracy." *Id.* at 588 n.21 (emphasis added).
- In *Pennsylvania Rail Co.* v. *Chamberlain*, which the Court described as "belonging to that class of cases where proven facts give equal support to each of two inconsistent inferences," the court upheld a grant of judgment as a matter of law "against the party upon whom rests the necessity of sustaining one of these inferences." 288 U.S. 333, 339 (1933).
- In *Gunning* v. *Cooley*, the Court stated that "[w]hen a plaintiff produces evidence that is consistent with an hypothesis that the defendant is not negligent, and also with one that he is, his proof tends to establish neither" and thus "the court should give a peremptory instruction to the jury." 281 U.S. 90, 95 (1930).

Such weighing of evidence at the summary judgment or directed verdict stage is inherently more invasive of the

jury's fact-finding role than at the pleading stage, in which all of plaintiffs' factual allegations are assumed to be true.

The Seventh Circuit ignored these cases. Its assertion about the Seventh Amendment was supported by no authority beyond a citation to dictum in *City of Monroe Employees Retirement System* v. *Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005). Pet. App. 20a. But that case *applied* the "most plausible inference" test. Its discussion of the Seventh Amendment cited only *SEC* v. *Infinity Group Co.*, 212 F.3d 180, 196 (3d Cir. 2000). That case—which upheld, on timeliness grounds, a denial of the defendants' request for a jury trial—said nothing to suggest that strengthening pleading standards implicated the Seventh Amendment.

CONCLUSION

The Seventh Circuit's "reasonable inference" standard is contrary to statutory language, legislative history and congressional purpose, and is not necessary to protect rights under the Seventh Amendment. The judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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